30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**January 2009, London**
Project:	**Conceptual Framework - phase D: The Reporting Entity**
Subject:	**Redeliberation of Issues (part 1) (Agenda paper 9)**

INTRODUCTION

1. The objective of this meeting is to discuss issues raised by respondents to the Discussion Paper (DP), *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity.*

2. This memorandum discusses the following issues:
   a. Description of the reporting entity
   b. Implications of the description of the reporting entity
   c. Group reporting entity
   d. Consolidated and parent-only financial statements.

3. The following issues will be discussed in future meetings:
   a. Entity perspective
   b. Definition of control
   c. Other control issues
   d. Other issues not addressed in the DP.

DESCRIPTION OF THE REPORTING ENTITY

4. In the DP, a reporting entity was broadly described as follows:

> A reporting entity is a circumscribed area of business activity of interest to present and potential equity investors, lenders, and other capital providers.

Description or Definition

5. Most respondents to the DP noted that the reporting entity concept should be described or defined in the conceptual framework.

6. A few respondents to the DP noted that any wording to describe a reporting entity will become a de facto definition. In fact, many respondents referred to the definition of a reporting entity even though the DP made it clear that the Boards' intention was to provide a broad description of a reporting entity rather than a precise definition.

7. The DP explained that developing a precise definition of a *reporting entity* would be similar to defining *assets*. The term *asset* was defined in the Boards' existing conceptual frameworks, and that definition was applied to financial reporting standards so that something had to meet the definition of an asset before it qualified as a potential candidate for recognition in a set of general purpose financial statements. Similarly, the precise definition of *reporting entity* would be applied to financial reporting standards so that the subject of a particular set of financial reports must meet the definition of a reporting entity before those financial reports can be described as being general purpose financial reports.

8. The Boards decided not to pursue the above approach. Rather, they decided to provide a general description of what constitutes a reporting entity in the context of general purpose financial reporting, particularly when a reporting entity should be aggregated or disaggregated. The staff did not find any further discussion regarding why the Boards decided to use the term *description* instead of *definition*.

9. The staff is of the view that there is little benefit, if any, in distinguishing between whether the Boards are providing a description or a definition of the reporting entity or whether it is broad or precise. Given that many respondents considered the broad description to be a broad definition, the staff recommends that, from

now on, the Boards consider the broad description to be a definition but that no special emphasis be placed on whether that definition is broad or precise.

Circumscribed Area of Business Activities

10. One respondent to the DP suggested that the idea of a *circumscribed area of business activity* be expanded by saying that the area will usually be circumscribed by legal or contractual rights or, in their absence, by an effective mechanism of sanctions.

11. While the above notion was implied in the DP, that point was not made clear. The staff recommends that the Boards clarify this point in the forthcoming Exposure Draft.

The Term "Circumscribed"

12. One respondent to the DP suggested that the Boards use a simpler term, such as *limited*, *specified*, or *particular*, instead of *circumscribed*.

13. The term *circumscribed* was used in the DP, perhaps because it was used in paragraph 202 of the 1986 FASB partial draft document, *Reporting Entity – Tentative Conclusions*, and that draft, although 20 years old, was part of the resources available to the current staff:

    > A reporting entity for general purpose financial reporting is an economic unit – a **circumscribed** area of economic interest consisting of a group of resources and the claims to or interests in them – that is a discrete resource of future cash flows to an identifiable group of investors, creditors, and others. [Emphasis added.]

14. The dictionary[1] defines *circumscribed* as "to constrict the range or activity of definitely and clearly." The staff thinks that definition is consistent with the Boards' intent and objective. The thesaurus[2] lists *limited* as a synonym for *circumscribed*.

15. The alternatives suggested for replacing the term *circumscribed* (other than the term *limited*) is likely to alter the intended definition. Moreover, all of these terms (including the term *limited*) are already used in U.S. GAAP and IFRSs and, therefore, adopting any of these alternatives may require further clarification as to

[1] Merriam-Webster Online Dictionary (http://www.merriam-webster.com/dictionary)
[2] Merriam-Webster Online Thesaurus (http://www.merriam-webster.com/thesaurus)

whether they have the same meaning as those used in other parts of U.S. GAAP or IFRSs. Accordingly, the staff recommends that the Boards retain the term *circumscribed*.

Business Activities

16. Many respondents to the DP asked the Boards to clarify whether the term *business activities* in the description of a reporting entity has the same meaning as that of *business* as defined in FASB Statement No. 141 (revised 2007), *Business Combinations,* or IFRS 3 (revised 2008), *Business Combinations*. Both Statement 141(R) and IFRS 3 define a *business* as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members or participants."

17. In the deliberations that led to the DP, the staff had originally used the term *economic activities* instead of *business activities*. The staff changed the term because the Boards decided to focus on business entities in the conceptual framework project and address not-for-profit issues later in Phase G. Thus, there was no intent to use the term *business* as defined in either Statement 141(R) or IFRS 3 or limit the definition of a reporting entity in that way.

18. The staff recommends that the Boards revert to the term *economic activity*. The staff is of the view that this would avoid confusion and also has the benefit of alleviating concerns raised by several respondents who noted that the term *business activity* is (or could be) inappropriate in the not-for-profit context.

Inactive Entities

19. A few respondents to the DP noted that the phrase "circumscribed area of business activity" suggests that the entity is active in its operations. However, in their view, a circumscribed area of business activity can be at times inactive and the description of a reporting entity should encompass such circumstances.

20. The staff is of the view that a reporting entity should be determined based on the economic activities the entity is capable of or authorized to conduct. In other words, the entity does not necessarily need to have actually conducted the economic activity – the ability to engage in the activity should suffice when

circumscribing the area of economic activities. The staff recommends that the Boards clarify this point in the forthcoming Exposure Draft.

"Of Interest To"

21. A few respondents to the DP noted that, despite the discussion of the link to the objective of financial reporting in paragraphs 23-28 of the DP, in their view the nature of interest of capital providers that the Boards are referring to is unclear. One of these respondents suggested that the Boards clarify that the nature of interest of capital providers is to obtain financial information about the entity that is *decision useful*.

22. The staff recommends that the Boards clarify that the nature of interest of capital providers is to obtain financial information that is useful in their decision making. This clarification is consistent with the intent of the Boards that is noted in paragraph 27 of the DP, which states, "By linking the description of a reporting entity to the objective of financial reporting, the boards' intention is to convey that the conceptual framework is focused on those circumscribed areas of business activity that are of interest to present and potential equity investors, lenders and other capital providers." The staff is of the view that this clarification would strengthen the link to the objective of financial reporting.

Capital Providers

23. While nearly half of the respondents to the DP agreed with the reference to *present and potential equity investors, lenders, and other capital providers,* one third of the respondents disagreed. Some other respondents to the DP noted that the reference to capital providers was inappropriate for not-for-profit organizations and suggested using the general term *users* or *resource providers*.

24. Because this part of the definition of a reporting entity flows directly from the primary users of financial reports identified in Phase A, the staff does not recommend specific changes to the definition at this point. Rather, the staff recommends that any changes to the primary users of financial reports in Phase A be carried over to the definition of a reporting entity.

"In Their Capacity As Capital Providers"

25. Capital providers may be involved with the reporting entity in multiple capacities. The staff recommends that the Boards clarify in the forthcoming Exposure Draft that the decision-useful information in question relates to capital providers in their capacity as capital providers.

Staff Recommendation

26. Based on the above discussions, the staff recommends that the reporting entity be defined as follows (it is marked from the description in the DP):

> A reporting entity is a circumscribed area of economic ~~business~~ activity whose financial information has the potential to be useful ~~of interest~~ to present and potential equity investors, lenders, and other capital providers in making decisions in their capacity as capital providers.

Question for the Boards

1. **Do the Boards agree, as discussed in paragraph 9, to refer to a *definition* rather than a *description* of a reporting entity and that no special emphasis be placed on whether that definition is broad or precise?**

2. **Do the Boards agree with the revised description (or now definition) of a *reporting entity* presented in paragraph 26, which incorporates the following changes?**

   a. **Replace *business activity* with *economic activity***
   b. **Clarify that the *interest* of capital providers is to *obtain financial information that has the potential to be useful in making decisions in their capacity as capital providers***
   c. **Clarify that capital providers refer to those *in their capacity as* capital providers**

3. **Do the Boards agree to clarify that a *circumscribed area of business activity* will usually be circumscribed by legal or contractual rights or, in their absence, by an effective mechanism of sanctions?**

4. **Do the Boards agree to clarify that a reporting entity should be determined based on the economic activities the entity is capable of or authorized to conduct?**

5. **Do the Boards agree that any changes in Phase A regarding the primary users of financial reports should be carried over to the definition of a reporting entity?**

IMPLICATIONS OF THE DESCRIPTION OF THE REPORTING ENTITY

Whether a Reporting Entity Must Be a Legal Entity

27. The Boards expressed its preliminary view that a reporting entity does not necessarily need to be a legal entity and, therefore, a sole proprietorship, branch, corporation, trust, partnership, and group of entities all could be a reporting entity. Most respondents to the DP agreed with the Boards' preliminary view.

Staff Recommendation

28. No new information was provided by respondents and the staff is unaware of any information that the Boards did not consider in reaching their preliminary view. Accordingly, the staff recommends that there be no change made to the preliminary view that a reporting entity does not necessarily need to be a legal entity.

Whether a Legal Entity Is Always a Reporting Entity

29. Several respondents to the DP suggested that there be a presumption that a legal entity should be the starting point and that the final document should specifically state that a legal entity always meets the definition of a reporting entity. Some jurisdictions require legal entities to prepare financial statements for statutory purposes, and constituents from these jurisdictions seemed to advocate this view.

30. However, not all jurisdictions require that all legal entities for statutory purposes prepare or file financial statements or, more precisely, require general purpose financial reports. In some cases in the United States, subsidiaries have been held by courts not to be separate from the parent because their records are not kept separately and their activities are not separate enough (for example, the same corporate officers run both, there are significant intercompany transactions that are not "arms length," and the like). Although such circumstances may be uncommon, this provides an example of when a legal entity might not be considered a reporting entity.

Staff Analysis and Recommendation

31. As indicated in the DP, legal structure helps to establish the boundaries of the reporting entity. However, the proposed revised definition of the reporting entity (as recommended in paragraph 26) indicates that the financial information of that circumscribed area must have the potential to be useful to capital providers in making decisions in their capacity as capital providers. Accordingly, the staff is of the view that, while legal entities are likely to meet the definition of a reporting entity, some may not. Moreover, the staff recommends that a conceptual discussion not include presumptions, which generally are reserved for standards and application guidance. However, the staff recommends that the forthcoming Exposure Draft clarify the point noted in this paragraph.

A Branch or Segment of a Legal Entity

32. In the DP, the Boards noted that a reporting entity could be a component of a legal entity such as a branch or a segment. The DP noted that in some jurisdictions, an unincorporated branch or an overseas corporation might be required or might choose to prepare general purpose financial reports, for example, to provide financial information to existing and potential creditors of the branch. A few respondents disagreed with the Boards' preliminary view, noting that this could lead to requiring the preparation of unreasonable sets of financial reports.

33. In the deliberations that led to the DP, the staff recommended that a branch or segment of a legal entity should not be precluded from being a reporting entity as long as the branch or segment has observable boundaries (that is, a circumscribed area of economic activities). When a company has a branch that operates in another country, the financial reports of that branch would likely provide useful information to lenders, suppliers, and other creditors in the country in which the branch operates to help them make decisions about allocating resources to the branch. Although they might have a claim against the assets of the overseas company, typically they would make their resource allocation decisions based on the expectation that their claims would be settled in the normal course of business, from the assets (or net cash inflows) of the branch.

Staff Analysis and Recommendation

34. The staff continues to support the view that a branch or segment **could** meet the definition of a reporting entity. However, the staff is also of the view that not all branches and segments would always meet the definition of a reporting entity. The reasoning is similar to the earlier discussion regarding whether all legal entities meet the definition of a reporting entity, in the sense that the existence of a branch or segment would not always lead to the conclusion that a reporting entity exists. Accordingly, the staff recommends that there be no change made to the Boards' preliminary view that a branch or segment of a legal entity could meet the description of a reporting entity.

Question for the Boards

6. Do the Boards agree with the following in relation to the implications of the definition of the reporting entity?

   a. Continue to support that a reporting entity need not be a legal entity

   b. Clarify that a legal entity likely would but not necessarily meet the definition of a reporting entity

   c. Continue to support that a branch or segment of a legal entity could meet the description of a reporting entity.

GROUP REPORTING ENTITY

35. The DP included a section on the group reporting entity. In that section, the Boards discussed the controlling entity model, the common control model, and the risks and rewards model.

Controlling Entity Model

36. In the DP, the Boards stated that the controlling entity model should be the primary basis for presenting the financial statements of the group reporting entity. Most respondents to the DP agreed with the Boards' preliminary view but several respondents noted that the Boards should not specify which model should be primary and which model should be secondary. These respondents noted that each model should be acknowledged as appropriate in its own right based on the facts and circumstances under consideration and that a hierarchical approach is inappropriate because it suggests that the common control model provides less useful financial information compared to the controlling entity model and that the common control model is an exception to the controlling entity model.

Common Control Model

37. In the DP, the Boards stated that the common control model should be used in some circumstances only. A majority of respondents to the DP agreed with the Boards' preliminary view.

38. The DP stated that a group reporting entity under the common control model would comprise entities under the control of the same controlling entity or body (for example, an individual investor, family, or other controlling entity).

Combined financial statements (that is, financial statements prepared under the common control model) would not include the controlling entity (the parent).

39. A few respondents to the DP noted that if a controlling entity does not need to be a legal entity, it might be possible to circumscribe two legal entities and determine that these two entities constitute a controlling entity and thus a reporting entity. These respondents noted that this interpretation would be useful for dual-listed companies and stapled entities and is likely to alleviate the need to have a separate common control model.

Risks and Rewards Model

40. In the DP, the Boards stated that the risks and rewards model should not be discussed as a standalone model but be discussed in the context of complementing the controlling entity model. Most respondents to the DP agreed with the Boards' preliminary view.

Other Possible Models

41. Paragraph 35 of the DP noted that:

> Given that an entity may have a variety of interests in, or relationships with, other entities, there are likely to be various approaches to circumscribing that area of business activity. However, it would not be a sufficient or effective use of the boards' resources to explore every conceivable approach. Therefore, the boards focused on three approaches that seem reasonable candidates, either because they are similar to the approach in use today (such as the controlling entity model) or because they have been suggested as a replacement for that approach (such as the risks and rewards model).

42. A few respondents noted that they were not convinced that the controlling entity model, the common control model, and the risks and rewards model were the only "reasonable candidates" in determining the composition of the group reporting entity.

43. Several respondents to the DP noted that there may be other sets of financial statements that provide decision-useful information to a wide range of users and, therefore, appear to meet the definition of general purpose financial statements. Financial statements for dual-listed companies and stapled entities were raised as examples.

Staff Analysis and Recommendation

44. As noted in the DP and supported by a majority of the respondents to the DP, the controlling entity model is likely to be used in most cases and the common control model would be used in some cases. The staff is of the view that the facts and circumstances surrounding a reporting entity should determine which of the two models to use for a given set of circumstances. As discussed earlier, the staff is of the view that a conceptual discussion should not include presumptions, which generally are reserved for standards and application guidance. Accordingly, the staff recommends that the Boards acknowledge that the controlling entity model would be used in most cases and the common control model in some cases but do not prioritize among these models.

45. A critical aspect of the controlling entity model and the common control model is the concept of control. As noted at the beginning of this memorandum, the staff expects to discuss the definition of control and other control issues at a future meeting.

46. As most respondents to the DP supported the Boards' preliminary view, the staff recommends that the forthcoming Exposure Draft not discuss the risks and rewards model as a standalone model but discuss it in the context of complementing the controlling entity model if appropriate. At the future meeting to discuss control issues, the staff expects to discuss whether and if so how the risks and rewards model should be referred to in the forthcoming Exposure Draft.

47. Respondents to the DP who commented on other possible models stated that there is an apparent contradiction to permit a very broad definition of a reporting entity but a restrictive definition of a group reporting entity. These respondents note that a circumscribed area of economic activity would meet the definition of a reporting entity if its financial information has the potential to be useful but the definition of a group reporting entity would permit only the controlling entity model and the common control model.

48. The staff acknowledges that there could be more than two models that have the potential of providing useful financial information of a reporting entity for a given set of circumstances. However, requiring a reporting entity to prepare financial

statements using all the models that have the potential to provide useful information is simply unrealistic.

49. The staff continues to support the Boards' preliminary view that it would not be a sufficient or effective use of the Boards' resources to explore every conceivable approach. The Boards should aim to choose the models that result in reporting entities providing financial statements that are most likely to provide decision-useful information to the greatest number of primary users. Accordingly, the staff recommends that the Boards do not discuss models other than the controlling entity model and the common control model in the forthcoming Exposure Draft. The staff is of the view that other possible models (including those for dual-listed companies and stapled entities), if necessary, should be addressed at the standards level or by each jurisdiction.

Question for the Boards

7. Do the Boards agree with the following regarding the group reporting entity?

   a. The forthcoming Exposure Draft should not prioritize among the controlling entity model and the common control model, although it would acknowledge that the controlling entity model would be used in most cases and the common control model in some cases

   b. The forthcoming Exposure Draft should not discuss the risks and rewards model as a standalone model but discuss it in the context of complementing the controlling entity model (if appropriate)

   c. The forthcoming Exposure Draft should not discuss other possible models (that is, models other than the controlling entity model and the common control model). Those models would be addressed at the standards level or by each jurisdiction if necessary.

CONSOLIDATED AND PARENT-ONLY FINANCIAL STATEMENTS

50. In the DP, the Boards expressed their preliminary view that:

   a. A parent entity should always present consolidated financial statements

   b. The conceptual framework should not preclude the presentation of parent-only financial statements, provided that they are included in the same financial report as the consolidated financial statements.

51. Most respondents to the DP agreed with the Boards' view that consolidated financial statements provide useful information to equity investors, lenders, and other capital providers.

52. A majority of the respondents to the DP agreed with the Boards' preliminary view that the conceptual framework should not preclude the presentation of parent-only financial statements, provided that they are included in the same financial report as consolidated financial statements.

53. Several respondents disagreed with the Boards' preliminary view and noted that consolidated financial statements should not be required when parent-only financial statements are presented in a financial report. Several other respondents argued that both consolidated financial statements and parent-only financial statements should be required to be presented together in financial reports. Yet few other respondents noted that it is not within the Boards' purview to prescribe which financial statements should or should not be prepared.

Staff Analysis and Recommendation

54. In the deliberations that led to the DP, the Boards decided not to reach a conclusion as to whether parent-only financial statements constitute general purpose financial statements. However, the staff is of the view that this issue is one of the most important issues to be addressed in the reporting entity phase of the conceptual framework and, therefore, recommends the Boards to make a decision on this issue.

55. The staff is of the view that consolidated financial statements represent a set of financial statements that are most likely to provide decision-useful information to the greatest number of primary users. When one entity has control over another entity, the cash flows and other benefits flowing from the parent to its capital providers often depend significantly on the cash flows and other benefits obtained from its subsidiaries, which in turn depend on the subsidiary's activities and the parent's actions in directing those subsidiaries. Accordingly, it would be useful to present the assets, liabilities, and activities of the parent and its subsidiaries as a single unit.

56. In some cases, an entity does not have a subsidiary, affiliate, or venturer's interest in a jointly controlled entity. Consistent with IAS 27, *Consolidated and Separate*

Financial Statements, the staff is of the view that financial statements of such entities should be considered consolidated financial statements. The staff recommends that the Boards clarify this point in the forthcoming Exposure Draft.

57. In the DP, the Boards stated their preliminary view is that the presentation of parent-only financial statements should be permitted only when consolidated financial statements are presented in the same financial report. This view, supported by a majority of respondents, implies that parent-only financial statements, in themselves, do not constitute general purpose financial statements.

58. The staff acknowledges that parent-only financial statements provide useful information in many cases. However, because parent-only financial statements rely on legal boundaries, there are cases where they clearly do not provide useful information and, in extreme cases, they could result in misleading information. Accordingly, the staff recommends that the Boards clarify in the forthcoming Exposure Draft that parent-only financial statements do not constitute general purpose financial statements but should be viewed as either special purpose financial statements or additional information to general purpose financial statements.

59. If the Boards are of the view that parent-only financial statements constitute general purpose financial statements, the staff recommends that the Boards change their preliminary view (that is, to permit the presentation of parent-only financial statements provided that they are included in the same financial report as consolidated financial statements) and permit the presentation of parent-only financial statements as standalone general purpose financial statements.

60. The staff is of the view that special purpose financial statements and additional information to general purpose financial statements should be discussed at the standards level or by each jurisdiction. The staff also notes that additional information, if discussed at the conceptual level, is a matter that might be best addressed in the currently inactive phase of the project on matters of presentation and disclosure, including the boundaries of financial reporting (Phase E). Accordingly, the staff recommends that the forthcoming Exposure Draft not discuss whether and if so how parent-only financial statements should be presented.

Question for the Boards

8. Do the Boards agree with the following regarding consolidated and parent-only financial statements?

a. Consolidated financial statements represent a set of financial statements that are most likely to provide decision-useful information to the greatest number of primary users

b. Financial statements of an entity that does not have a subsidiary, affiliate, or venturer's interest in a jointly controlled entity should be considered consolidated financial statements

c. Parent-only financial statements, in themselves, do not constitute general purpose financial statements but should be viewed as either special purpose financial statements or additional information to general purpose financial statements

d. The forthcoming Exposure Draft should not discuss whether and if so how parent-only financial statements should be presented.